Financing FARMER COOPERATIVES

FCS Educational Circular 5
Farmer Cooperative Service
U. S. Department of Agriculture

how a cooperative's financial needs can be determined and how the capital structure is set up.

Wisely selected financing policies mean much to your association, but even the most conservative, carefully administered financial plan may be of little avail if your cooperative's original financing was neither sound nor adequate.

How do farmers who plan to organize cooperatively determine how much money they will need to start their organization on a sound basis? The answer to that question may best be provided through a hypothetical illustration of a group of growers in a fruit-producing area who form a cooperative.

When these growers have definitely agreed upon the economic need for a cooperative, they must determine whether or not an adequate volume of fruit will be marketed through the new association to assure efficient operation. For the purpose of this illustration, it may be assumed that enough producers will join the cooperative to guarantee a volume of 50,000 boxes of fruit the first season.

On each box of fruit the cooperative expects to have a margin between the proceeds of sale and the returns it will make to members sufficient to pay operating expenses and build reserves. For example, the difference between the sale price and the grower's return may be 50 cents a box, of which 40 cents is earmarked for operating costs, leaving 10 cents for reserves and possible patronage refunds.

The expected volume of 50,000 boxes, on which operating expenses are 40 cents a box, indicates the need of $20,000 for operating capital. The land, buildings, and equipment necessary to conduct operations are valued at $25,000. The total, $45,000, is the amount of money which must be raised to conduct operations.

As a general proposition, the capital needs of a cooperative are dependent on what you propose to do. For example, it takes much more capital to own facilities and conduct a processing operation than it does to run a brokerage business. Capital requirements also vary for different types of cooperatives. You can usually evolve a formula, like the illustration given, to help you estimate how much capital will be needed.

Sources of Capital

WHEN you buy a farm, you may borrow money to finance its purchase, but the more you can pay outright from your own funds, the more secure you are in your ownership. A cooperative may also borrow money for its land, buildings, equipment, and other fixed assets. However, you and the other members must furnish a substantial proportion of the capital required because no one else can be expected to finance your business—or even to help you finance your business—unless you own a substantial equity therein.

For operating capital, it is considered sound business for the cooperative to obtain short-term loans, just as you may borrow to get your crop started and pay back when it is harvested.

With the amount of money necessary to conduct operations determined, the fruit growers in our illustration must next obtain the re-

quired $45,000. Two avenues lie open to them: (1) subscription of funds by the members, and (2) borrowing. The extent to which they utilize each method of raising money depends upon varying circumstances, but an important cooperative principle will serve to guide them to some extent.

This principle is that members should invest in their cooperative an amount sufficient to make them realize that they have a financial stake in the organization which it is to their own interest to protect. In short, members should make investments in their cooperatives sufficient to provide adequate capital and an ample credit base for a full 12 months' operation. If the producers ignore this principle and attempt to start with little or no membership investment, they are courting failure.

This does not imply that producers must raise their entire $45,000 through membership subscription. Except in rare instances, such a procedure would be difficult. In order to bridge the gap between an adequate membership investment in the capital and the whole amount needed, the cooperative may borrow money either from banks for cooperatives or other sources.

There is no fixed rule as to the relation of the amount of borrowed capital to membership investment in a new cooperative, but the Farm Credit Act of 1933 restricts the amount which the banks for cooperatives may loan on fixed assets—that is, on land, buildings, and equipment—to 60 percent of their value.

The fruit growers can accept this restriction as a sound one. Thus on their facilities, valued at $25,000, the new cooperative may borrow $15,000, with the members providing $10,000. With a 50,000-box volume, the individual member's share in the fixed capital will be 20 cents a box. If a grower expects to deliver 1,000 boxes of fruit to the cooperative in the first season, he may reasonably be asked to contribute $200 to the fixed capital.

How about his share of the operating capital for the first year? Ordinarily, a well-established cooperative may soundly borrow most of its operating funds. But for a new marketing cooperative borrowing operating capital and offering proper security for payment of the loan it is good practice to have at least $1 of its own funds for every $4 of borrowed money. Farm supply cooperatives should start with $1 of their money for every $2 borrowed.

Thus, our new fruit association, needing $20,000 to operate for a season, may borrow $16,000 and raise $4,000 from its members. With the expected volume of 50,000 boxes, the assessment will be 8 cents a box. To this may be added 2 cents a box to cover errors in estimating costs or volume.

So, the grower who plans to deliver 1,000 boxes of fruit to his cooperative may add to his $200 fixed capital subscription an $80 contribution to the operating capital, and $20 as a safeguard against increasing costs or reduced volume—a total of $300. The membership as a whole will furnish $15,000 of the original capital of $45,000.

Members' Subscriptions

It is highly desirable that subscription to original capital be made by members in proportion to the volume they expect to deliver to the association, and that the subscription be in cash. Some associations have sold preferred securities

to outsiders to obtain the necessary original capital, but such a procedure may weaken the members' interest and the association is likely to be looked upon as "the other fellow's" instead of "ours."

Furthermore, inasmuch as members of cooperatives expect to share in patronage refunds in proportion to the volume they deliver, it is equitable that they subscribe to the original capital on the same basis. If the association revolves its capital, as described later, periodic adjustment is made of the capital contributions of members.

It is often found that prospective members of a new cooperative do not have adequate funds or credit to subscribe a substantial amount of the original capital. If this is the case, it is probable the undertaking should be deferred until later.

Frequently prospective members borrow on their individual notes the funds necessary to subscribe to the original capital and give an order on the cooperative to pay such borrowings from the proceeds of sale. In some cases the association has endorsed the individual notes, but such a procedure is considered unsound and inequitable because it creates a liability on the part of the association which may handicap its own financial standing, and it may be called upon to make good the debts of a few members at the expense of the remainder.

Interest on Membership Capital

During the first years of operation, cooperatives ordinarily forego payment of interest on membership capital. If capital has been subscribed in proportion to use and there is no marked change in patronage there is in reality little reason to pay interest. Any margins or savings not distributed as patronage refunds are used to build reserves.

In the early history of an association members may have a capital investment approximately in proportion to the use they make of it. Hence, the payment of interest is in effect "taking money out of one pocket and putting it into another." However, after an organization has operated for a period of years there usually are changes in membership and in volume of business done by individual members. Then the payment of a moderate rate of interest on membership capital would tend to offset to some extent the disadvantage to members who may have sizeable investments in the association in excess of what their proportionate shares based on current patronage would be.

It is unwise, however, to make interest payment on members' equities mandatory even after the association has operated for a period of years. Unforeseen circumstances might arise to jeopardize the future of the association if interest became due and funds were not available to make payment. The advisable procedure is to provide in the bylaws that the payment of interest on membership capital be at the discretion of the board of directors. This gives leeway without binding the association.

Borrowings

Facility Loans

In arranging to borrow to finance its land, buildings, and equipment, a cooperative usually obtains credit on a long-term basis. Only under unusual circumstances could an association repay the entire obligation in a single year. The period of

the loan depends upon a number of factors, including the policies of the lender. From the association's standpoint, the desirable period is the one which will permit repayment of the debt as soon as possible without working an undue hardship on its members.

Our fruit growers' cooperative, used as an example, was to have borrowed $15,000 on its facilities. Repayment of this loan would be made from the proceeds of sale of the fruit it handles. It may be assumed that of the 10 cents a box set aside for reserves and patronage refunds, 1 cent is allotted to the reserves, and 9 cents to patronage refunds. If this were done, 6 cents a box might be deducted from the sale price to repay the loan. This arrangement would be attractive to members since they would receive a patronage refund in excess of the amount deducted for the capital loan repayment.

At this rate of deduction, with a volume averaging 50,000 boxes a year, the association would pay off the $15,000 loan in 5 years at $3,000 a year.

It should be noted that the procedure outlined contemplates an authorized deduction from the proceeds of sale for capital purposes—namely, to repay the loan. This is advisable because unforeseen circumstances might arise which would make it impossible to pay patronage refunds. If reliance were placed on patronage refunds as a source of capital, the association might at times be unable to meet its obligations. Thus, in planning the original financial structure of a cooperative, provision may well be made to finance the organization through capital deductions or "retains" from the proceeds of sale. Farm supply associations usually build their capital from operating margins although a few add a charge, such as 50 cents a ton, to their sales accounts for capital purposes.

Operating Loans

Cooperatives usually obtain credit for operating capital on a short-term basis. Here the period corresponds with the length of time required to assemble, process, pack, transport, and sell the products, and collect the sales proceeds. This varies from commodity to commodity but corresponds roughly with the marketing season. Sometimes the sale proceeds of the first products are used to finance later marketings and returns are made to members at a later date, but, as a rule, it is customary to make returns to members as quickly as possible and to repay borrowings at the end of the season when all sales have been made.

If the commodities handled are marketed in rather steady volume throughout the year, operating funds are usually borrowed for a period of 1 year and new loans sought annually. The same is true in the case of farm supply associations handling a uniform volume. Many associations which have a distinct seasonal peak in volume but operate throughout the year plan to build their own operating capital to a point where they need borrow only for their peak needs. Some associations make arrangements for credit to permit borrowing and repayment from time to time within a given year and with interest due on outstanding balances.

One of the principal reasons to borrow operating capital on a short-term basis is that the rates are usually lower than for long-term

loans. However, on May 1, 1957, the interest rates of the banks for cooperatives for both operating and facility loans ranged from 4 to 5 percent. The interest rates on commodity loans varied from 3½ to 4½ percent. Lenders review operating loans frequently because, if operations are not satisfactory, they can either withdraw their credit or demand correction in operating methods and policies.

Commodity Loans

Some cooperatives, particularly those operating on a consignment basis, are authorized by the membership to borrow on the commodities they handle. Commodity loans are generally made against farm products that are stored or warehoused. With some associations this is an important phase of their financial operations. Where commodity loans are made, lending institutions advance cooperatives a certain percentage of the market value of the commodities handled. The cooperative in turn may advance its growers the same or a different percentage of the value of the commodities being delivered to the association by its members.

Revolving Capital Plan

YOUR association may be among the many which have adopted the "revolving" plan of capitalization. If it is, you are participating in a purely cooperative practice whereby it is intended that patrons contribute to the association's capital exactly in proportion to the business done with the cooperative and each year receive repayment of the capital contribution made in an earlier year.

The plan has been likened to a water wheel, picking up water, using it to create the power that turns the mill machinery, and returning the water to the millstream. Your contribution plays its part in the cooperative's capital for a period of years and creates many advantages not found in other financing plans. Then it returns to you.

The revolving type of capital structure provides that members' contributions of capital be returned to them periodically. This plan has been developed in response to a situation peculiar to cooperative undertakings. Members expect to gain advantages through the association in proportion to the use they make of it rather than in proportion to the amount of invested capital. However, when a member ceases to patronize a cooperative, his point of view changes and he becomes concerned about dividends and returns on invested capital. If, therefore, some provision is not made to return the withdrawing member's investment, as time goes on and more and more members cease farming, a sharp conflict of interest may arise between the present patrons and the ex-patrons. Furthermore, it would appear there is little reason why an ex-patron-member should be supplying capital without return to an association for the benefit of the current members.

The revolving capital structure tends to maintain the members' investment in the association in proportion to the amount of business they transact through it. This is a distinct advantage from a number

of standpoints. If the patrons have an investment to protect, they are likely to continue to patronize the association even though temporary difficulties may be encountered. They are also likely to insist that the association take no undue business risks—such as the extension of credit on too liberal terms.

Furthermore, the revolving capital structure offers a convenient way to keep the voting control of the organization in the hands of those who use it. At the same time, it minimizes the amount of nonmember business because associations which have once acquired a substantial amount of capital are able to admit new members on the payment of a small membership fee and permit them to furnish their capital contributions over a period of years rather than require them to make a large initial investment. This factor is important because the amount of nonmember business has a bearing on the legal eligibility of an association to borrow from the banks for cooperatives and on exemption under income tax laws.

How Revolving Plan Operates

The operation of a revolving capital structure is shown in tables 1 and 2. In the construction of table 1, the fruit cooperative is again taken as an example. It first began operation in 1951 with facilities costing $25,000, a mortgage debt of $15,000, an original investment on the part of members of $15,000, and capital retains of $3,000 each year. The association will not revolve any portion of the membership capital until the mortgage debt is repaid. In order to simplify the illustration, it is assumed that there is no change in the association's total capital requirements over the 1951–1957 period.

Table 2 shows the revolution of capital belonging to the member who markets 1,000 boxes a year through the association during the 1951–1957 period under consideration. A capital retain of 6 cents per unit is deducted annually from sales and the member's original investment in 1953 is $300.

Tables 1 and 2 show the associa-

Table 1.—Capital statement of a cooperative on revolving capital basis

Year	Total membership investment at beginning of year	Mortgage debt at beginning of year	Capital added by 6-cent-per-unit deduction	Capital revolved	Total membership investment at end of year	Total capital
1951	$15, 000	$15, 000	$3, 000		$18, 000	$33, 000
1952	18, 000	12, 000	3, 000		21, 000	33, 000
1953	21, 000	9, 000	3, 000		24, 000	33, 000
1954	24, 000	6, 000	3, 000		27, 000	33, 000
1955	27, 000	3, 000	3, 000		30, 000	33, 000
1956	30, 000		3, 000	$3, 000	30, 000	33, 000
1957 [1]	30, 000		3, 000	3, 000	30, 000	33, 000

[1] And so on, if operations are successful and no more funds are needed for capital.

Table 2.—A member's capital equity account in the foregoing association

Year	Investment at beginning of year	Capital contributed by 6-cent-per-unit investment on 1,000 units a year	Capital revolved to member	Investment at end of year
1951	$300	$60		$360
1952	360	60		420
1953	420	60		480
1954	480	60		540
1955	540	60		600
1956	600	60	$60	600
1957 [1]	600	60	60	600

[1] And so on, if operations are successful and no more funds are needed by the association for capital.

tion revolving no portion of its capital until the mortgage debt is paid in full. Some associations do revolve a part of their capital prior to that time with funds obtained from other sources such as savings that are not distributed as patronage refunds. The principal considerations are the amount of funds available and the extent to which capital revolution can be made without jeopardizing the credit standing of the association.

Legal Considerations

It is important to an association planning to build its capital structure on the revolving plan as presented in the illustration to provide authorization in the bylaws or marketing contract for deductions from the members' proceeds of sale for this purpose. If associations retain for capital purposes a part of each year's operating margins on a revolving fund basis, they should make proper bylaw provision therefor. At the same time, it is advisable to set forth in the bylaws or contract other purposes for which deductions may be made, such as reserves and necessary operating expenses. The courts have held that no matter how advisable or essential deductions, other than those authorized may appear, they cannot properly be made.

It is also important to set forth in the bylaws that the membership capital is junior to the rights of creditors. At the same time, it is essential that the bylaws state the authority the directors may exercise in revolving capital funds. The tendency is to provide that the board of directors shall have broad authority as to the size of the capital fund, the time of revolving of capital, and the amount of the deduction for capital purposes.

Adapted to Both Stock and Nonstock Associations

The foregoing considerations apply whether the cooperative is organized as a capital stock association or a nonstock association. Many people fail to recognize this fact. Numerous nonstock associations operate on a revolving fund basis. But the number of capital

stock cooperatives using the revolving plan is increasing. It is possible, of course, to draw the legal instruments of a capital stock association in such a manner that the capital stock will revolve in the same manner as the membership capital of a nonstock organization. Many cooperatives have a "mixed capital structure" where a part of their membership equity capital is handled on a revolving fund basis and another part is not.

The membership capital in nonstock associations is known by a variety of names such as advance funds, revolving funds, withholdings repayable, members' reserves, and members' investments. From a financial point of view all of them are merely names for capital.

Another circumstance has led some to believe it is only nonstock associations which operate on a revolving capital plan. It is that some nonstock associations have attempted to build their entire capital structure by deductions from the proceeds of sales without a substantial original investment on the part of the members. When a nonstock association is organized, it is possible for prospective members to subscribe to the capital funds, by whatever name they are called, and to receive evidence of their equity in the association, just as it is possible to subscribe to the capital stock, either preferred or common, of a stock association.

Need of Reserves

WHEN lean years come to your farm and that of your neighbor, they quickly affect your cooperative. Patronage, whether it be in products marketed or in supplies bought, falls off. Financially, your association must be prepared to carry on through the period of diminished patronage. To provide a safeguard against such contingencies and other attacks upon your capital in the cooperative, the association should set up adequate reserves. They are really just one of the necessary costs of running a sound business, and, fairly enough, they are contributed by you and the other members in exact proportion to the business you put through your cooperative.

Mention has been made of the advisability of planning the capital structure to provide for reserves. The purpose of reserves, is, first, to provide funds to meet unforseen circumstances and, second, to protect members' capital investments.

Some associations provide for a definite deduction from the proceeds of sale for reserves, while others set aside reserves from margins or savings before distributing patronage refunds.

Amount of Reserves

A sound practice for cooperatives is to build reserves gradually to an amount considered adequate to meet unusual situations which might arise. For example, some associations accumulate reserves until the amount is sufficient to pay the expenses which would be incurred if a crop failure made it necessary for the plant to remain idle for a season. Associations storing commodities from one part of the marketing season to another seek to build their reserves to a point at

which they would cover losses that might be sustained if prices decline during the storage period. Farm supply associations carrying heavy inventories aim to have reserves adequate to cover losses which might be incurred from price fluctuations before an inventory can be moved.

Under income tax regulations cooperatives qualifying for exemption are permitted to accumulate and maintain reasonable reserves for necessary purposes. However, the association must pay Federal income taxes on any amounts placed in reserve unless individual members are given notice of the amounts placed to their credit in these reserves in accord with income tax regulations. When notified, cooperative patrons are required under present income tax regulations to take these amounts into account in preparing their own income tax returns when they affect the cost of their business operations.

The discussion above refers to general reserves or reserves for contingencies. It is a common business practice to establish valuation reserves such as depreciation allowances and bad debt allowances. These are distinct and separate from equity reserves and are expense charges to current operations.

How Cooperatives Budget Expenditures

IF YOUR cooperative governs its expenditures with a budget, it is following generally accepted business practice. Governments budget their money and housewives budget their food allowances. Your cooperative may use a similar system to determine in advance how it may expend to best advantage the money you contribute to its operating capital.

In estimating and checking the probable operating costs, revenues, and other factors affecting the financing of our fruit growers' cooperative the construction of a budget was involved.

Under certain circumstances, it is relatively simple to obtain the essential information for a new association's budget expenditures, while in other instances the data are difficult to procure. After a cooperative has operated for an entire season, however, the preparation of a budget is comparatively simple.

For a new cooperative, a budget is helpful in determining whether or not the undertaking is feasible and in estimating financial requirements. Established associations find the budget indispensable in keeping expenditures in line with revenues and the functions the cooperative performs. The management is frequently urged to undertake additional functions and to expend funds for purposes which may be worthy, but if the budget does not provide for such expenditures the manager is justified in denying them.

As an illustration of budget preparation, table 3 outlines the expenses our fruit-handling cooperative might incur during a season. The expenses total $20,000, or 40 cents a box if the expected 50,000 boxes are delivered. Instead of charging members 40 cents a box for handling their fruit, the association makes the figure 50 cents to provide a margin of safety. At the

Table 3.—Illustrative expense budget for a cooperative

Item	Amount
Office salaries, including clerical salaries	$3, 800
Packing labor, at 10 cents a package	5, 000
Packages and supplies, at 12 cents a package	6, 000
Depreciation of buildings and equipment	1, 250
Interest on long- and short-term borrowings	1, 000
Taxes and insurance	750
Office expense, including communication expense	750
Allowance for bad debts	500
Legal expense	150
Unpredictable expense	300
Audit expense	500
Total estimated expenses	20, 000

The foregoing budget does not include all the items or correspond with the segregation that may be found in the budget of a specific association. If the products handled are processed, manufacturing and processing costs are important budget items. Similarly, if products are stored for considerable periods, storage charges may appear as a distinct item.

end of the season, as pointed out before, the amounts not used to pay operating costs are paid in cash or allocated to members and retained as equity capital.

Insofar as possible, the charge made to the member is kept in line with competitive handling charges—that is, with the margin generally prevailing in the industry between the sales price of the fruit and the returns to the grower. The only justification for higher charges is in distinctly superior service by the cooperative.

The item of superior service must not be overlooked as cooperatives are frequently organized to obtain improved services in marketing or acquisition of farm supplies. However, it is important to keep the competitive situation in mind because members frequently judge the efficiency of their cooperative on the basis of cost rather than service. Furthermore, if a budget shows estimated expenses per unit to be considerably more than competitive handling charges, a serious question is raised as to the advisability of organizing a new cooperative; or if an association had been operating for some time, it raises the question of the advisability of liquidating or merging operations with other agencies.

Use of Audits and Financial Statements

AS LONG as you have a financial interest in your cooperative, you have every right to know the facts about the financial condition of the association. Periodic financial statements provide the information you want. If a careful audit is made, you may be assured that the statement presents an accurate and sufficiently complete picture of its true financial status.

At the end of each season of a fiscal year it is a sound practice to have an audit made by a competent accountant—preferably a certified public accountant. Some associations have quarterly audits to supplement annual audits, an advisable

practice if operations are extensive and large inventories are carried.

The auditor should be selected by the board of directors rather than by the manager because one of the functions of the auditor is to review the operations directed by the manager. The auditor is thus responsible to the board and any suggestions or critical comments he may have to present should be made to the board.

There is a tendency at times to try to economize with a limited audit or by employing someone who will make the audit for a small fee. Usually such audits are worthless because little more is done than copy the bookkeeper's records. It cannot be too strongly urged that audits should be thorough and made by competent persons.

Purposes of an Audit

One of the primary purposes of an audit is to determine the accuracy of the records of the transactions conducted during a specified period. This is particularly important to cooperatives because they deal with many persons whose returns or savings are dependent upon the accuracy of the accounting. A second purpose is to verify the correctness of the assets, liabilities, and capital of the association. At the same time the audit serves to detect and prevent fraud. A third purpose is to obtain in written form a summary of the association's financial condition and operating results. The auditor can also be of assistance in determining whether the cooperative is complying with income tax regulations, particularly as between member and nonmember business.

Utility of Audits

The audit is of aid in presenting the affairs of the association to those from whom it expects to obtain credit. It serves too as a source of information which will aid in planning future operations. Trends in operations are frequently revealed which, if detected in time, may be corrected before substantial losses are incurred.

Audits also bring to an organization an outside viewpoint on methods of accounting and business procedure. This helps keep accounting expenses at a minimum and perfects checks for preventing losses.

For the purposes of the members, the auditor's findings ordinarily are presented in the form of an annual financial statement. Too frequently members pass by their association's financial statement as it comes to them in their membership publication or otherwise and look upon its seeemingly formidable columns of figures as puzzles too difficult to solve.

Financial statements are actually concise, well-planned listings of the assets, liabilities, and operating results which indicate the cooperative's financial condition. They are not difficult to understand with a little study, and once comprehended present a clear picture of how the business is being conducted.

To keep in touch with the cooperative's financial standing is just as much a part of the member's job as is his actual contribution of money. Since he obviously cannot make a personal check of the association's books, the financial statements are presented periodically to furnish him with information on the association's financial affairs.

Questions and Problems

1. What is the customary handling charge per unit in your community for a specific agricultural product?

2. How many units does the cooperative you have selected handle?

3. What is the total investment in plant and equipment of the association you have selected?

4. What is the total membership investment?

5. What is the unit cost of operations?

6. How much money does it take to operate the association for a year?

7. Assuming a similar association were about to organize, prepare a statement showing the amount of initial membership capital that would be required and the amount that might be borrowed.

8. Outline a plan for obtaining membership capital that would be equitable to producers with small as well as large volume.

9. What terms and conditions would you desire on a long-term loan to finance the plant and equipment?

10. Prepare a plan and statement showing how a long-time loan would be repaid.

11. Assume you were to borrow operating funds to run the cooperative for a year. Prepare a statement that you could present to a bank showing how the funds would be used and when and how they would be repaid.

12. What are the advantages of a revolving type of financial structure?

13. Construct a table showing how the revolving type of capital structure operates.

14. What are the principal reasons for establishing reserves in cooperatives? What is the source of the reserves?

15. What are the purposes of an audit?

16. Obtain the financial statement of a specific cooperative. Analyze it from the standpoint of the members' investment in the organization. Obtain the articles and bylaws of the cooperative and, with your analysis in mind, prepare a statement showing how the financial structure might be improved.

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"You and Your Co-op" Series

Other circulars in this series, describing the personal relationship between you and your cooperative, are available from the Farmer Cooperative Service, U. S. Department of Agriculture.

The series includes:

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